Mohammad Sadli

A Few Notes on the Subject of Regional Autonomy

(Translated)

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Some Notes on Local Autonomy

Prof. M. Sadli
Chairman of Yayasan Indonesia Forum

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The Transfer of Authority to Kabupaten (district/city) and to Province

The Law 22/ 1999 of local autonomy follows the principle that the central government authority is to be transferred to the Kabupaten/Kota (regencies/cities) instead of to the Provinces. This was the political choice of Habibie's Government in 1999 that raises a question: why not transfer authority to the province, and then the province would share the power with the Kabupaten?

It may have been wrong choice. However, at present the Wahid Government, and the Parliament, have no intention to review that main principle. Might they be afraid to open the Pandora Box?

Hsuman resource are more available at the provincial level. In the Kabupaten, the human resources to run local government are not sufficiently available. This is not the case for local parliament (DPRD). At the provincial level, there would be excess personnel for the operation of local government, since the "kantor wilayah" (local office), as the representative of the central department, should be merged into the "kantor dinas" as the provincial government apparatus. In doing this, the excess personnel in the national and provincial level could be transferred to Kabupaten. However in the transition period it will create various problems, since the respective personnel will experience this as career downgrading.

There is a suspicion, or prejudice, that Suharto's government -- and also the Habibie's as its extension -- by design preferred the transfer of authority to the Kabupaten instead of Province. The number of kabupaten in Indonesia is 350 and will increase to about 400. On the other hand, there will be only around 30 provinces. The kabupaten is a much smaller government entity than province. Consequently the possibility of kabupaten to ask for freedom is also smaller. From the point of view of keeping the integration of Indonesia, the transfer to kabupaten is safer than to the province. This hypothesis seems reasonable, but too late. How could we imagine that some kabupaten in Aceh and Irian Jaya would be able to prevent the demand for freedom in those provinces?

Law 22/ 1999 holds the principle that central government will retain power in the fields of defense, foreign affairs, fiscal, monetary, and taxation policy, foreign trade, justice, and some other affairs which are considered important and strategic. For the other fields, the main function of central government is to define the standards, norms, general planning, and so on. The provincial government is given the authority for the inter-kabupaten affairs.

The Government Decree no. 25/2000, which is the implementation of the Law 22/1999, shows the “long” lists for central and provincial government and the “short” lists for Kabupaten. However those “long” lists of authority are not to be interpreted that the central government plays tricks again *(freeing the head but holding the tail,* in the Indonesian proverb). The long lists of functions of the central and provincial government only describe, department by department or field by field, the principles of planning norms and functions for the department at the central level and the inter-Kabupaten assignments for provincial government. Meanwhile the rest, actually the biggest part, is assumed to be kabupaten authority.

However, it is certain that many the central and provincial government officers will complain that the unitary state apparatus has been knocked down. On the other side, the bupatis (Heads of Kabupatens) will also complain that the kabupaten will be unable to find independent financing to run the assignments transferred to Kabupaten.

The new problem, ideally and ideologically, is who owns the natural resources. In the past, and according to the Constitution, all of the resources below the earth surface belong to the nation and have to be used for the maximum benefit of the entire nation. As long as the Constitution remains unchanged, this principle is still valid. However, the new reality demands the recognition that the people in the regions also have a right to the natural resources benefits in the regions. This principle then is to be reflected in various sharing formulas among kebupatens, provinces and central government, relating to natural resources exploitation. Since the “local” level can be interpreted as kabupaten or province, are the natural resources owned by the province or kabupaten? Therefore, it should be declared clearly that the Constitution principle is still valid, but that now there is an agreement of revenue sharing between Kabupaten and Province based on some standard or measures. Then the question is what measures to apply. It could be population, land area, or something else. Furthermore, the locals should interpret benefits not only in revenue (money) terms, but also in terms of job and business opportunities for local people.

The not-rich-in-natural-resources provinces that are rich in human resource (for example Yogyakarta, Central Java, and East Java) are now also demanding tax revenue sharing from human-resources-intensive economic activities. They consider that the tax revenue sharing, as imposed only in the natural resources, is not fair.

The tax revenue sharing of natural resources exploitation is only implemented for the royalties, and not for corporate income tax. Royalties are the tax that is charged for extracting every natural resources quantity. Corporate income tax can be zero if the mining company suffers loss, but the royalties have to be paid as long as there is production. The taxation principle in Indonesia, in the past, is that all income taxes, corporate or individual, are to be collected by central government. The same principle is applied to Value Added Tax as the form of Sales Tax.

II. Fiscal Aspects

The main problem in this topic is the lack of PAD (local owned revenue) toward the total local government expenditure budget. This is because the "big" resources of PAD, which are the tax of property in urban areas and tax of motor vehicle, are more available in such relatively big cities as the capital of a province, but less available in the (capital city of) a kabupaten; especially outside of Java. The second cause of the smallness of PAD is that a few "fat" taxes, such as corporate and personal income tax, sales tax (VAT in Indonesia), import tax, excise of -tobacco, soft-drink, and alcohol, are collected by central government and allocated to locals through the general allocation fund. The taxes that can be transferred to locals are the taxes of ownership or wealth, taxes of land, taxes of motor vehicle, and taxes of other object located in the regions. Beside that, the user charges are also transferred. Actually, the initial meaning of user charge is a payment, or cost reimbursement, for the service provided, so it is not a tax.

Because of those fiscal principles, the fiscal independence level (ratio of PAD to total of budget) is considered low; from a minimum of about 5% for poor Kabupaten outside Java to 60% or more for a metropolitan city such as Jakarta. To most Kabupatens, the maximum level is 20-30%, as it is for most Provinces except for West Java, East Java, and Bali. (In Bali the tourists contribute substantial restaurant and hotel tax.)

Does the local government have to be more independent and keep up the PAD? Of course, there is no such thing as 100% independent. Even in the federal countries, such as US, Canada, or Australia, the subsidy from federal government is always substantial and significant. It is useless to apply the benchmark that a province or kabupaten has to achieve at least X % of independence level. It is more important to create a formula of revenue sharing for various "fat" taxes collected by central government. The DAU (General Allocation Fund) arrangement has followed an automatic formula. First, the amount of DAU is at least 25% of all domestic revenue of central government. Second, the allocation to local governments follows a transparent and objective formula (reflecting local capacity, area, geographical condition, and income level). Furthermore this formula can be reevaluated periodically. However, the amount of central government revenue might be changed due to changes in oil prices and the growth of the economy. Therefore the amount received by local is also uncertain. The improvement of PAD, which has a higher revenue certainty, is necessary to assure the stability of local revenue.

The revenue sharing of corporate income tax is more difficult to implement, since the location of the head office (which pays the income tax) is usually different from the operating area. It is preferable that the corporate income tax be collected by central government, without revenue sharing, and the local government obtain its portion through DAU. In the other side, the personal income tax can be shared with regard to the residence location of taxpayers. This still may create some complications. An example is the case of a rich businessman living outside Jakarta and working in Jakarta. Perhaps the local government where he lives and the local government where he works (usually not far away) can reach an agreement on revenue sharing. Also there might be several kinds of income tax; for central government and for residential locations, as in US.

The sales tax in some countries are collected at the local or state level. However, in Indonesia the sales tax is more in the shape of value-added tax. The administration of VAT is more complicated since it has a multilevel calculation. For manufactured goods, the VAT is levied when it comes out from the factory, but the wholesale and retail trading actually pay the VAT. In Indonesia this trading level is exempted from the obligation to pay VAT. Therefore the VAT is not considered as a pure one since the VAT payers are the producers themselves. Can the hybrid sales tax -- which applies the VAT in the factory or production location, and applies the sales tax in the retail level (with a lesser rate) -- be applied in Indonesia? It seems that it is already the case for the big retailers such as Makro, Hero (the big supermarkets in Indonesia) and so on. Meanwhile the small retailer is still exempted.

The allocation of tax revenue should fulfill two measures; first, the right transaction location; second, sufficient funds to provide social services. Between these two requirements there are always conflicts and trade-offs which is hard to solve by any formulas created by the central government. In practice, the process of bargaining between central and local, and among locals, should be allowed. The result of that process might be different in different times and circumstances.

III. Investment Affairs

Law 22/1999 specifying the authority of local government does not state that investment is still a function of the central authority. It implies that this affair becomes a local authority. Only oil and gas mining, as stated in Government decree 25/2000, which is the implementation of Law 22/1999, is a function of central authority. The local level is defined as Kabupaten or Kota, unless the area involved is inter-Kabupaten (such as in mining, plantation or forestry). If the area is inter-Kabupaten, it will be managed by the provincial government. However what is the content of “affair?” This must be understood to include the entrance permit. If the central government cannot close an industrial field, due to excessive competition, the government will not be able to conduct national trade policy. (There are some suggestions, as from the World Bank, that the developing countries should not have an industrial policy -- but that’s another story.)

The role of Foreign Investment up to now relates to central government authority as stated by the Law of Foreign Investment. Does the Law have to be changed? It is possible. However, foreign investment is also can be viewed as part of foreign affairs. Official foreign relationships (G to G) are still the authority of central government. Foreign trade policy is also the authority of central government. Should the entrance of foreign investment be through the central government, too? There is no hard reason. However if there are special considerations such as to have stronger guarantees (for example, that there would be no nationalization, the free transfer of profit, the obligation of central government to be responsible to investment insurance supported by bilateral international agreement with OPIC or US, etc.) it can be decided that foreign investment is still the authority of central government. So far there is no such decision. As we have seen previously, if the government has to be able to manage trade and industrial policy, including to regulate competition, the entrance of foreign investment should be made through central government. However, this idea will be disagreed with by local government, as it looks like *"freeing the head but keeping the tail."*

How can we manage large capital investment, at the level of hundreds of millions USD? This could occur in the mining sector, infrastructure, and even industry. Is it that, for the sake of legal guarantees of this big investment, the entrance permit and operation permit should be issued by central government? Probably for the next ten years, this principle is still crucial.

The test case now is the large mining projects which have already run, based on production contracts with the central government, with consultation with parliament. These contracts have the force of law. The legal guarantees and protection by government for several big projects are now being tested. The examples are Freeport McMoran in Irian Jaya, the gold mining operation of Newmont Minahasa in North Sulawesi, Kalimantan Prima Coal in East Kalimantan, nickel mining of Inco in South Sulawesi, etc. These projects encounter problems with local government (Newmont Minahasa, Freeport, Inco), problems with labor unions (KPC), and problems with indigenous people regarding the amount of compensation (Newmont Minahasa). Mostly in these cases, in the midst of social unrest, the central government has no ability to provide protection since it can't order or control the local government, police, arm forces, labor unions, and so on. These symptoms might be a special and transitional case. However, when will this transitional period conclude?

The local government actually has to be cooperative with the investors, since they will create the job opportunities and economic growth. However, as the local government is always short of funds, it is often attempting to collect taxes, user charges and other payments, especially from a company that processes natural resources. A new perspective holds that natural resources exploitation has to create substantial direct benefits to the local people. Although the mining companies (foreign investment) have production contracts with the central government, including the obligation to pay various taxes, the local government – which always assumes that the direct benefit is not sufficient – may be tempted to collect additional payments without considering the provisions of production contracts with the central government. The big mining projects (including Pertamina in the past) always create enclaves providing a modern luxurious life in the midst of poor traditional community. In that condition, social integration is lacking, and community development is expensive and always considered insufficient. Furthermore the central government always neglects to allocate special expenditures from tax revenue to reduce this enclave symptom.

There is different perception between the natural resource exploitation projects and manufacture or service industry projects. For industries and services, it is easier to imagine that the company will move somewhere where the local government is more cooperative. However this argument does not apply to natural resources, due to the uniqueness of location. Industry can “escape,” but not for natural resource.

Does the local government (province, kabupaten, kota) have to promote investment? And how will it be done? Mostly the local government owns the Local Planning Agency (Bappeda) and Investment Office (Dinas Investasi). The thing that has to be done is to increase their performance. Many Investment Offices complain that they are not given sufficient operational funds. This of course depends on the priority scale of the respective local government: the choice is between the priority for new investment and the priority for improving social welfare. It has to be considered that the budget fund is always not enough.

Providing the public infrastructure (roads, electricity, telephone, etc) and qualified human resources can stimulate investment. This also depends on the expenditure budget for infrastructure development and education.

IV Providing Public Services.

This is the main duty of local government in the future. The existential reason for local autonomy is that the most effective way to provide the social services is by local government, which is better informed of the community’s social needs. However, in economics it should be separated between “need,” which is unlimited, and “demand,” which is the factor of need backed by purchasing power. Education, health, security, environmental comfort, etc., have their costs. In the past time the funding was obtained from the central government as a subsidy. This subsidy still exists, as the General Allocation Fund sharing. However, the routine (current) costs, especially local government personnel and routine operation expenditure, is also costly. Because of that, many social services have to be financed by the user charges. Some fraction (large or small) of education, health, social economic infrastructure, and other costs, in the end have to be the burden of the local people.

The poverty alleviation function does not need to be revised. In the broad sense it can follow the previous programs that had been done by central government. However the application in the local has to be intelligent according to local condition and the limited fund and ability.

Since the most effective approach to poverty alleviation is by providing job opportunities and new business opportunities, this function is clearly related to the investment stimulus. It is applicable not only to big companies, but also to pay attention in developing small and medium enterprises. In many kabupatens from the poor area, the Small and Medium enterprise sector is more important and has more potential than large-scale enterprises

Since production depends heavily on market and marketing, the trade sector must not be ignored by government. The local government has to be cooperative in achieving trade flows. On one side, the infrastructure for trade and commercial flows has to be improved; in other side it has to be restrained so as not to increase the high cost economy. It is not an easy balance since every infrastructure improvement has its costs. Therefore studies of efficiency (cost cutting) have to be conducted. This is the role of local universities.

V. Foreign Affairs

The development of either national or local economies closely depends on foreign relations. Foreign economic relations consist of trade, investment, borrowing, and grants.

Many provinces and state governments overseas conduct trade promotion abroad by themselves. Some provinces in Indonesia are supposed to do similar promotion. It seems that the kabupaten is too small an entity for such activities, with the exception of the big cities (Jakarta, Surabaya, Medan, etc). Such promotion should be done through cooperation between local government and local trade and commerce organizations and associations. Trade promotion can't be separated from investment promotion.

The local government is allowed to pursue borrowing from abroad (Law 25/1999). However such borrowing has to be approved by the central government. This is normal, since it is a matter of guarantee: if the local government cannot repay the debt, the central government has to. This principle is also applied for state owned or local owned enterprise.

Credit offerings from abroad seem quite abundant. However it must be watched carefully, since all credit needs a guarantee, and the strongest guarantee could only be given by central government.

If foreign credits are offered to local government for infrastructure projects, what is the guarantee for repayment? If the projects are for public infrastructure, say for supporting agriculture or for building the roads, the repayment will be taken from the tax collected by central or local. Since most of the local governments have limited tax bases, the projection for increasing tax capacity has to be taken into account in the project's feasibility study. These feasibility studies are very important and utilize rare expertise and experience in the local level. It is the role of Local Planning Agency (Bappeda), National Planning Agency (Bappenas), and also the local universities.

In order not to discourage the low-income community (which is the majority in most locals), the new infrastructure financed by foreign borrowing should be self-liquidating through a user charge or toll rate. The principle is that the service user has to pay directly. It is the toll road principle (pay-as-you-go). This might increase the cost; however if the benefits exceed the rate, it could be feasible. Actually the toll rate or user charge for service is sort of sales tax. In the poor community to collect a sales tax is more effective than to collect the income tax.

In the post national economic crisis period, the decision to allow foreign borrowing for local government is problematic for central government. It is because the central government itself still needs to borrow. However, to refuse all of the demands is also politically difficult It creates the impression that the central government is selfish to allow borrowing for itself but not for others. The central government may give priority to the natural resource rich provinces, such as Aceh, Irian Jaya, Riau and East Kalimantan, since their government revenue has foreign reserve components. If those provinces want to increase the people's wealth, they should build up public infrastructure (roads, ports, telephone, urban infrastructure, etc)

VI. Regional Economy Growth

Local autonomy in the end has to support wider economic growth. As long as economic development is highly dependent on central government (Jakarta) for decision-making, development and growth would not be optimal according to theory. Dramatic growth has occurred only around Jakarta and, whether by design or by accident, Java Island. This is because the infrastructure development mostly takes place in Java, and because the concept of need is measured by population. Why do the rich natural resources areas, such Aceh, Riau, Kalimantan Timor and Irian Jaya, lag behind Java? It is because of the lack of infrastructure. Furthermore the investments and business permits have to be handled in Jakarta. This often means that the successful entrepreneur with a growing company moves to Jakarta. The decision-making for a big company is usually centralized in Jakarta and the company representatives in the provinces only take care of the day-to-day operation.

Can local autonomy, which shifts business licensing to local government, stimulate more investment and business expansion in the provinces? This assumption has to be proved in practice. Licensing is not only for investment, which in the past had to be done in Jakarta, but also includes permits from the Investment and Capital Market Agency (Bapepam), from the Justice Department, for expanded credit, for special export/import, etc. These procedures might still have to be done in Jakarta.

The tendency for big company to locate its head office in Jakarta might persist as long as the status quo is not changing much. At present, in Sumatra, new economic activities come from the capital and company centers in Medan (and Singapore). This might be unchanged over the next five to ten years. The accelerating growth rate in most locals has to be generated from agriculture and the small medium enterprise sector, which are triggered locally. However, aside from the local government role, these efforts still need technological input, marketing, capital, and so on. Those are still designed from outside.

Local autonomy could also increase consumption expenditure or non-investment expenditure. This could occur as the local government, including the legislature, becomes larger. An increase of this expenditure will cut into development expenditure. It seems likely that in the early stages local autonomy would only increase routine government expenditure; the expectation that autonomy will accelerate economic growth as a whole (national) will have to wait a long time.

VII. The Role of Local Universities

The local university has an important role to play in the implementation of local autonomy since it is the source of know-how and the place for human resources education.

The local university is usually located in the capital of a province, not in the capital of a kabupaten or other cities. The human resources quality of local government (kabupaten) and the human resources of political parties, especially the representatives in Parliament, need to be improved in order to be able to do their jobs.

With any limitations in most of the university, its staff has to be able to conduct training/education, research, and consultation for the executive, legislative, and judicial branches and for the public (local press and NGO). Recently in several areas, there have been demands for training, research, and consultation from executives to the university -- not for the national university, such as Gadjahmada University, but the local university such as University of Muhammadiyah at Surakarta.

The local university has to cooperate with other local as well as national universities on networking. The networking relations in this era are greatly facilitated by electronic communication such as web-site and email. With this medium, networking even becomes global.

Local autonomy in Indonesia has been the focus of attention, and some worries, by international agencies such as World Bank and IMF, as well as big bilateral donors such as USAID, Japan, UK, and Germany. They worry that if the experiment fails, national integration will be threatened. The concern expressed is that the implementation of local autonomy would be a fiscal nightmare. The donors are anxious that at some point the central government will not be able to repay its foreign debt, since it has to provide too much funding for local governments.

This seminar of local autonomy in Andalas University is also the example of national and international networking among Andalas University, LPEM-FEUI, University of Maryland, ISEI, Yayasan Indonesia Forum, and others; and is enabled by the grant of USAID.